The Yale Law Journal

Volume 78, Number 5, April 1969

Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares

Marvin A. Chirelstein†

The growth of share repurchasing as an element of financial strategy for large, publicly held corporations[1] raises an issue of interpretation under the federal income tax that has significance both for ordinary investors and for the revenues. That issue—whether a corporate distribution which results in the retirement of outstanding shares should be treated as essentially equivalent to a taxable dividend—is an entirely familiar one to tax lawyers, but it is one that has typically been confined to closely held or family-owned corporations, whose cash distributions are likely to take whatever form best suits the individual tax and financial interests of their controlling shareholders. By contrast, the owner of stock in a public company is powerless to dictate the form in which corporate distributions may be cast, and the absence of a family or other personal relationship between management and shareholders is generally expected to relieve management of any special concern for the tax objectives of shareholders. Moreover, those objectives are probably so diverse and conflicting that no single distribution policy would seem capable of satisfying all shareholders in equal measure. Consequently, public companies with scattered stockholdings do not commonly generate dividend equivalence problems, and the ordinary investor is rarely an object of the tax collector's suspicion.

† Professor of Law, Yale Law School. B.A. 1950, University of California; J.D. 1953, University of Chicago.

1. *See* Guthart, *More Companies Are Buying Back Their Stock*, 43 HARV. BUS. REV. 40 (Mar.-Apr. 1965). The author, in a study of the repurchasing activities of corporations listed on the New York Stock Exchange, reports that in 1963, the latest year examined, almost 15 per cent of the total trading in the shares of General Motors, General Electric, and Standard Oil of New Jersey was attributable to the repurchase of shares by the companies themselves, while in the same year more than 100 listed companies repurchased enough of their own stock to account for 5 per cent or more of total trading in their securities. *Id.* 40. Corporate funds paid out for reacquired shares increased from $273.9 million in 1954 to $1,302.9 million in 1963 and in the latter years actually exceeded the total of capital raised by new stock issues. *Id.* 44. In a later study the same author reports that in 1965 New York Stock Exchange corporations repurchased more than 37,000,000 of their own shares at a cost of almost $2 billion. Guthart, *Why Companies Are Buying Back Their Own Stock*, 23 FINANCIAL ANALYSTS J. 105, 106 (1967).

For these reasons, perhaps, share repurchasing has attracted little attention from the Treasury and the bar, although the apparent tax advantages of repurchasing have been widely stressed by financial commentators in recent years.[2] Thus, suppose that *X* Corporation, with one million shares of common stock outstanding, is a stable, non-growth company which annually generates $1 million of earnings after tax, or $1 per share. Unable to reinvest its earnings at a profitable rate of return, *X* decides to distribute the $1 million to its shareholders. The stock of *X*, which normally sells at 10 times earnings, is currently quoted at $11, *i.e.*, normal value of $10 plus $1 per share available for distribution.

If *X* distributes the $1 million as a dividend, and if the shareholders of *X* pay tax at an average rate of 30 per cent, then the net wealth per share of an average shareholder following the distribution will be $10.70, *i.e.*, normal value of *X* stock ($10) plus the after-tax value of the dividend ($0.70). In the alternative, if *X* uses the $1 million to repurchase its own shares at $11 per share, it will be able to retire approximately 90,909 shares at that price. Earnings per share will then rise to about $1.10 on the 909,091 shares that remain outstanding, and, with no change in the multiplier of 10, the value of the stock held by non-selling shareholders will be $11, as compared with an average net wealth per share of $10.70 if a dividend is paid. Shareholders who have chosen to resell their stock will hold $11 cash for each share sold less any capital gain tax resulting from the sale, with the net proceeds varying from individual to individual depending on original cost.

Without detriment to those who prefer to sell, therefore, but provided always that the only tax imposed is a capital gain tax on sellers disposing of appreciated shares, *X* Corporation can benefit non-selling shareholders by applying its "unwanted" cash assets to the retirement of outstanding stock instead of paying dividends. Aside from tax effects, though possibly bearing some relation thereto, share repurchase has the further advantage of providing an option to shareholders, since those who desire current income can obtain it by selling a portion of their shares, while those who do not can avoid it by retaining all of theirs.

The critical assumptions that underlie the tax results just described are, first, that repurchase produces capital gain (or loss) for share-

2. *See, e.g.*, Bierman & West, *The Acquisition of Common Stock by the Corporate Issuer*, 21 J. OF FINANCE 687 (1966); Brigham, *The Profitability of a Firm's Purchase of Its Own Common Stock*, 7 CALIF. MANAGEMENT REV. 69 (Winter 1964); Farrar & Selwyn, *Taxes, Corporate Financial Policy and the Return to Investors*, 20 NAT'L TAX J. 444 (1967).

holders who choose to surrender their shares to the company, and second, that repurchase has no present tax consequences (other than the postponement of gain or loss) for those who do not. The Internal Revenue Service has thus far raised no question about the legitimacy of these results as a matter of law. They are also either ignored or taken for granted by the tax bar, presumably for the reason, mentioned above, that dividend equivalence problems are rarely associated with publicly held corporations. The income tax treatment of share repurchases is important in dollar terms, however, and the purpose of this paper is to consider whether the assumptions described as critical are truly as well-founded as appears to be supposed.

I. Financial Consequences of Share Repurchasing

Before the issue of proper tax treatment of repurchases is discussed, it may be useful to draw some conclusions about share repurchasing as a financial device, especially as it compares and contrasts with conventional dividend payments. The specific question is whether, apart from taxes, share repurchasing accomplishes one or more financial goals which are not achieved by ordinary dividend distributions, either at all or in the same degree. As indicated below, analysis suggests that share repurchasing and ordinary dividend payments are largely interchangeable from an economic standpoint, although considerations of management self-interest may occasionally lead to a preference for the former.

Financial writers generally seem to agree that "the most important motivation behind stock repurchase [is] the desire to reduce the equity capital of the company."[3] Many corporations have experienced an exceptional growth in liquid assets during the past dozen years because of highly profitable operations, accelerated depreciation practices, and the levelling off of new investment requirements within the industry itself. Lacking internal investment opportunities which promise an adequate rate of return, and having cash balances on hand greater than needed to finance normal expansion requirements, these companies have concluded in many instances that excess working capital can best be employed to shrink the equity base through the repurchase of common shares. Apart from any comparison with dividends, self-ownership is said to be preferable to purchasing shares in other cor-

3. Guthart, *Why Companies Are Buying Back Their Own Stock*, 23 FINANCIAL ANALYSTS J. 105, 106 (1967); *see* Brigham, *supra* note 2.

porations because of management's intimate knowledge of its own company's earnings prospects. In addition, the company's earnings per share are directly increased by reducing the number of shares outstanding. By contrast, if funds are invested in the stock of other corporations, the investing company's earnings are increased by no more than the dividends received.

In a similar vein, some commentators have suggested that share repurchasing may be useful in helping to maintain or achieve a desired relationship between debt and equity in the firm's capital structure.[4] It is conventionally assumed that a corporation can reduce its overall cost of capital by replacing equity with cheaper borrowed funds up to some safe and supportable degree of leverage. Thus a company which regards itself as under-leveraged can improve its capital structure by issuing debt securities and applying the proceeds to the retirement of common shares. Similarly, a firm which considers that it already has achieved a cost-minimizing debt-equity ratio, but which finds that ratio threatened by the rapid accumulation of retained earnings, may repurchase outstanding shares as a means of preserving the existing proportion. In either event share repurchase has been recommended as a preferred procedure for contracting the corporation's equity base where a higher ratio of debt to equity is deemed consistent with the desired level of financial risk.

Equity contraction can be accepted without challenge as a valid financial objective. When income tax distinctions are ignored, however, it is apparent that this goal is as well served by paying cash dividends in the conventional manner as by repurchasing outstanding shares. The point can be seen most easily if the repurchase program is assumed (unrealistically for the moment) to be carried out on a pro rata basis. Since equity-contraction can be achieved only by a cash payment to shareholders, and since cash can be paid out as effectively by dividend as by repurchase, the advantage of the repurchase procedure, if any, must reside in its comparative effect on aggregate share values. Since pro rata repurchasing will not alter proportionate stockholdings, a favorable effect on aggregate share values would normally occur only if the value of the corporation, viewed as an entity, would be enhanced by a reduction or limitation in the number of its ownership units. That, however, is unlikely to be the result. The value of

4. Ellis, *Repurchase Stock to Revitalize Equity*, 43 HARV. BUS. REV. 119 (July-Aug. 1965). *See* Porterfield, *Dividend Policy and Shareholders' Wealth*, in FINANCIAL RESEARCH AND MANAGEMENT DECISIONS 54 (A. Robichek ed. 1967); J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 210 (1968).

the firm, conventionally, is a function of two factors: the anticipated earnings available for distribution and the rate at which those earnings are capitalized by the market. It is clear that neither factor is affected by the number of common shares outstanding, and it should be equally clear that neither is in any way determined by the form in which distributions are made to shareholders. As a theoretical matter, therefore, and apart from taxes, it is relatively easy to conclude that nothing is accomplished through a pro rata repurchase that could not as well be accomplished through an ordinary dividend unaccompanied by the surrender of shares.

If the pro rata assumption is discarded, the question just considered becomes slightly (though only slightly) more complex. Stock repurchasing, whether by ordinary market transactions or by public invitation to tender, is inevitably non-pro rata in the case of a publicly held corporation. Thus, at least that factor—non-pro rata distribution—is present and serves to distinguish repurchases from pro rata dividends. Its significance, however, hardly lies in the field of valuation, since the size and composition of the shareholder group before and after the repurchase obviously have no bearing on anticipated earnings and the capitalization rate. To put it otherwise, neither of the conventional elements of valuation responds to the number or identity either of the corporation's continuing shareholders or of those who prefer to sell out for cash. The sole significance of the non-pro rata factor, therefore, is that stock ownership is concentrated in the hands of shareholders who do not choose to sell or tender their shares, just as it would be if the same individuals received cash dividends which they then used to purchase additional shares of their corporation in the market. Thus, by repurchasing outstanding shares the corporation shortcuts the investment decision which non-selling shareholders might have made for themselves if the same funds had been distributed to them as pro rata dividends. This investment decision is, of course, negatively reflected in the shareholder's election to retain his shares while others are surrendering theirs; but apart from differences in the level of consciousness at which such individual choices are made the essential equivalence to a dividend-cum-purchase is apparent.

On the whole these comments apply with equal force whether the company's purpose is to distribute excess working capital or to change or restore debt-equity relationships. Either goal can justify a cash distribution. To that end, however, share repurchase and dividends are perfect substitutes for each other because both procedures result in cash payments of equal amount. Again, the difference between them, aside from taxes, is merely that repurchase itself produces a de facto adjustment of individual investment portfolios, while dividend payments leave such adjustments to be carried out by shareholders buying and selling stock in the market.

In many instances, share repurchasing is said to be prompted by the corporation's obligation to issue shares under employee stock option plans (or in connection with acquisitions).[5] The avowed purpose is to avoid dilution of existing shareholders' equity by maintaining the number of shares outstanding at present levels. It is clear, at the same time, that repurchasing shares for reissue to optionees does not protect the value of the shareholder's equity against dilution, since optionees gain at the shareholders' expense whether they receive newly issued or treasury stock or accept cash for the cancellation of their rights. Concededly, the decision to repurchase shares has the effect of restoring (that is, of increasing) the proportionate equity interests of those shareholders who do not choose to sell. But that is a goal that can be attained only by distributing cash otherwise available for dividends, and as usual it is one which the shareholders could accomplish for themselves by reinvesting such dividends in the company's shares. Beyond this, it is also true that the corporation may decide to make a cash distribution in response to the exercise of stock options simply because it is unable to put the additional capital to a profitable internal use. Again, however, for that purpose dividends and repurchase are interchangeable.

Finally, mention should be made of the notion, frequently found in the financial literature, that share repurchase can sometimes be recommended as a suitable investment for the company's residual funds. The meaning of "investment" in this context is not always clear, but most writers appear to have nothing more in mind than that a distribution of excess working capital is the obvious and appropriate course to follow when attractive internal investment opportunities are lacking. Used this way the term "investment" seems to refer only to the de facto adjustment of individual portfolios described above, *i.e.*, to the contraction of the company's equity base and to the accompanying increase in earnings per share on the reduced number of shares outstanding. It is difficult to perceive any other meaning. Certainly repurchasing possesses none of the customary attributes of internal asset acquisition, such as the purchase of plant and equipment. In the latter case the size of the enterprise is maintained or possibly increased

5. Guthart, *supra* note 3, at 107.

and there is no decline in shareholders' equity. In the former, cash assets are reduced precisely because a profitable opportunity for internal asset acquisition is lacking, and the corporation's equity is diminished correspondingly. Although stock repurchasing increases the earnings per share, there is no real increase in the earnings available for distribution. The contrast with investment in conventional operating assets is evident.

Having stressed that share repurchasing merely increases the percentage interests held by continuing shareholders, one may conjecture that the management of a public corporation would rarely act so as to alter the proportionate interests of the company's shareholders if it were not for the tax advantages. Although shareholders desire and expect that management will exercise its own judgment in determining whether corporate funds should be committed internally, used to retire debt, or paid out as dividends, adjusting levels of participation among the individual shareholders would seem to lie outside the customary scope of the directors' responsibility. That decision, essentially in the realm of portfolio management, is presumably better left to the judgment of the shareholders themselves than accomplished on their behalf through corporate action. Even if management regards the current market price of the company's stock as low in relation to the intrinsic investment value of the security, there seems to be no justifiable reason why corporate assets should be used directly to benefit some shareholders at the expense of others. Indeed, one would think that management would and perhaps ought to be indifferent as to whether an anticipated rise in market price is shared in by a larger or a smaller group of shareholders.

All this is not to suggest that management's own self-interest is never involved in the choice of distribution procedure. Thus, an increase in ordinary dividend payments, even in the form of a year-end extra, might make it necessary for the corporation to offer the shareholders some explanation if the increased payment was not coincident with a substantial rise in reported net earnings. Assuming that the dividend increase merely reflects the absence of attractive investment opportunities, the explanation, if perfectly forthright, would tend to cast doubt on management's ability because it would suggest that the company had reached a condition of partial liquidation.[6] On the other hand, to the extent that share repurchasing is carried out through ordinary brokerage transactions in the market, the entire matter is

6. Remark of David Jones in discussion following Porterfield, *supra* note 4, at 69-70.

less public and the shareholders may neither expect nor seek a detailed explanation of the transaction. Moreover, since company executives who hold unexercised stock options do not share in ordinary pro rata dividend payments, a dividend declaration which is desirable from the viewpoint of shareholders may be much less so from the viewpoint of optionees.[7] By contrast, share repurchase confers the same quantitative benefit on option holders in the form of increased option values as it does on non-selling shareholders in the form of increased share values. Hence, from the optionees' viewpoint, share repurchase may be superior to ordinary dividends as a means of distributing excess working capital. Finally, but presumably least prevalent or important, shares may be repurchased from a dissident shareholder to secure the control status of an inside group, an objective for which ordinary dividends are largely useless.

Apart from these considerations of management preference, the general conclusion that has been reached, here and elsewhere,[8] is that share repurchase and dividends are perfect substitutes for each other as long as income tax distinctions are disregarded. Once personal taxes are taken into account, however, an important difference appears, and the relative advantage of repurchasing becomes evident. Under a tax structure which favors capital gains over ordinary income the stock of a corporation which elects to package cash distributions as capital gain obviously is worth more to shareholders than that of an identical firm which presents investors with taxable dividends. Accordingly, the decision to repurchase stock can be justified as a strategy for maximizing the value of the company's shares by increasing the after-tax value of its cash distributions. Indeed, assuming that the economic effects of repurchase are equal to or no worse than those arising from the payment of ordinary dividends, the logical though somewhat startling conclusion is that repurchase should substitute entirely for dividends, with the quantity of shares available for resale being restored from time to time through stock dividends or splits. This is precisely the model generally assumed by financial theorists in integrating personal taxes into a normative theory of share valuation.[9] Since the personal income attainable by shareholders from a given stream of corporate earnings is increased if cash distributions are made in the form of low-

7. *See* W. Baumol, The Stock Market and Economic Efficiency 87 (1965).

8. *See* works cited note 2 *supra*. *But see* Elton & Gruber, *The Effect of Share Repurchase on the Value of the Firm*, 23 J. of Finance 135 (1968), suggesting that differences in transaction costs may in some cases tend to favor ordinary dividends.

9. Farrar & Selwyn, *supra* note 2; *see* Myers, *Taxes, Corporate Financial Policy and the Return to Investors: Comment*, 20 Nat'l Tax J. 455 (1967).

taxed capital gain rather than as ordinary income, an optimal distribution policy is described as one in which stock is always repurchased in lieu of paying cash dividends. To be sure, as a practical matter, corporate directors do not and cannot go so far. Nevertheless, the substantial and continuing growth in repurchasing by major firms suggests that its benefits are now very widely understood.

II. Optional Stock Redemptions and Optional Dividends

The assumption that repurchase results in capital gain (or loss) to the selling shareholders derives from Section 302 of the Internal Revenue Code. That section provides that a distribution in redemption of common stock shall be treated as an "exchange" if the redemption (a) is "not essentially equivalent to a dividend," (b) reduces the shareholder's percentage ownership of the corporation's voting stock to less than 80 per cent of such ownership before the redemption, or (c) completely terminates the shareholder's interest in the corporation. A redemption that meets any one of these tests produces capital gain or loss to the shareholder whose stock is redeemed; a redemption that meets none of them is treated as a dividend taxable as ordinary income.

The percentage ownership and complete termination tests, which appear in Sections 302(b)(2) and 302(b)(3), specifically focus on the non-pro rata character of the redemption and contain detailed rules which, if carefully complied with, assure that a redemption distribution will not be treated as a dividend to its recipient. The "not essentially equivalent" test of Section 302(b)(1), though not limited in terms to non-pro rata redemptions, is generally thought to subsume the same criterion and to provide capital gain or loss for non-pro rata distributions which do not meet the specific requirements of Sections 302(b)(2) or 302(b)(3) but which for other reasons seem not to involve the avoidance of ordinary dividend income. Isolated redemptions of part of the company's preferred stock, or redemptions of common which are pro rata only because stock belonging to one independent or hostile family member is attributed to another, are among the illustrations commonly given of the operation of Section 302(b)(1).[10]

Of course, the factor of non-pro rata distribution is present virtually by definition in the case of repurchases by a publicly held corporation. In many and perhaps most instances the selling shareholder

10. *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 292 (1966).

disposes of all or the greater number of his shares, thereby meeting the reduction in percentage of ownership or complete termination of interest test. Even if he does not—as where there is an "over-tender" and the corporation accepts shares pro rata from those tendering—the fact that the selling shareholder occupies a minority status and therefore lacks control over the company's dividend policy is generally thought sufficient to bring the redemption within the "not essentially equivalent" category of Section 302(b)(1).

The tax treatment of continuing shareholders is not specifically set forth in the Code. It is well established by court decisions[11] and administrative rulings,[12] however, that a non-redeeming shareholder realizes no gain or loss or dividend income solely because all or a portion of the stock of other shareholders was redeemed, even though the effect of the redemption is to increase his percentage ownership of the corporation. This result can be supported by inference from Section 302 itself: since Congress went to considerable trouble in that section to delineate precise rules for assuring that qualifying redemptions would not be impeded by the threat of dividend income to the shareholder whose stock is redeemed, it should not be presumed that an equally serious impediment was intended to survive in the form of a dividend threat to non-redeeming shareholders in such instances. The inference, in brief, is that Congress intended Section 302 to preempt the redemption field for tax purposes. Alternatively, the same conclusion can be reached under the general Code requirement of realization, since the non-redeeming shareholder receives nothing directly from the corporate treasury that can be characterized as a dividend distribution. To be sure, his percentage interest in the corporation increases as a result of the redemption; but since the increase is offset by a reduction in size of the entity itself, the dollar value of the stock owned by the non-redeeming shareholder is unaffected by the distribution. Hence, even the element of indirect enrichment is lacking.

To summarize, the technical argument for favorable tax treatment of selling shareholders rests on Section 302, and of non-selling shareholders on the same provision, inferentially, with support from the general Code requirement of realization. These rules contemplate a pattern in which one shareholder or group of shareholders withdraws from the firm, wholly or partly, with a consequent increase in the percentage ownership of the remaining shareholders. Under long-standing

11. *E.g.*, Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958).
12. *E.g.*, Rev. Rul. 59-286, 1959-2 CUM. BULL. 103; Rev. Rul. 58-614, 1958-2 CUM. BULL. 920.

decisions which are elaborately articulated in the Code and in cases and rulings, the withdrawing shareholder is treated as having sold or exchanged a capital asset, while the continuing shareholders are considered to have realized nothing from the corporation that can be viewed as a taxable gain. Although the withdrawal or shift in interest is financed out of the corporate treasury rather than out of individual bank accounts, the transaction is regarded as "similar to a common stock shareholder's sale of [all or] a part of his common stock to another person."[13]

These results must be considered among the basic structural elements of Subchapter C and are no longer open to any fundamental challenge. Nevertheless, it is important to realize that they reflect a conscious and deliberate policy choice and do not flow inevitably from the transaction itself. Suppose *A* and *B*, equal shareholders, agree after negotiation that *B* shall withdraw from the firm by selling his stock to the corporation at a stated price for cash. The decision to treat the redemption of *B*'s stock as a capital transaction cannot be explained in a wholly satisfactory way simply by regarding the redemption as an analogue to a sale of those shares to another individual, although that is the justification most commonly offered. It is true that the redemption reduces *B*'s interest to zero and increases *A*'s interest to 100 per cent. But the fact that these changes are accompanied by a distribution of corporate assets impairs the sale analogy for at least two reasons. First, the redemption of *B's* stock permanently reduces the corporation's earnings and profits account whereas a sale has no effect on earnings and profits. Amounts which might later be taxed as ordinary dividends to the buyer of shares are thus converted into capital gain by the redemption. Second, and more important in the present context, the redemption distribution is non-pro rata—and thus resembles a conventional sale—only because *A* agrees to waive his right to a proportionate share of it and to redirect that share to *B*. The transaction can, therefore, be seen as a two-step procedure involving, first, a pro rata dividend to *A* and *B* which reduces by half the value of the company's stock, and second, an election by *A* to apply to the purchase price of *B*'s interest his one-half share of the total received, after which the stock formerly owned by *B* is cancelled. So viewed, the redemption device is merely a shortcut by which the two steps collapse into one.

These observations tend to confirm that Section 302 was designed

13. Cohen, Surrey, Tarleau & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 COLUM. L. REV. 1, 32 (1952).

with a specific policy goal in mind and not simply to carry out general principles relating to the tax treatment of stock sales. Most would agree that the aim of the section is to facilitate occasional, and often major, shifts in ownership interests among the shareholders of closely-held or family-owned corporations for whose shares no active market exists apart from the company itself. That, of course, is the image of Section 302 which tax lawyers generally have in mind; virtually every technical detail in the section confirms that Congress did as well. Thus, family attribution rules and other provisions for constructive ownership of stock, restrictions relating to the redemption of stock from controlling shareholders, the disproportionality standard itself together with the prohibition against planned series of redemptions which are pro rata in the aggregate—these rules obviously contemplate a tightly knit shareholder group whose individual interests are virtually identical to those of the corporation. Hence if taxing redemptions in accordance with the two-step characterization mentioned above is rejected in this context, as of course it must be, the reason is not that it fails to describe the transaction accurately but that it runs counter to the basic legislative aim, which is to bear lightly on withdrawals from incorporated partnerships.

Transactions of the latter sort, though perhaps formally initiated by the corporation, are necessarily the product of negotiation and agreement among the shareholders. That is their distinguishing mark. Redemption price, terms of payment, total number of shares to be redeemed, even the tax consequences, must be bargained out and agreed to before the redemption is authorized. The reason, of course, is that the redemption is intended to alter the stock interests of particular individuals in specified ways—for example, through the surrender of control by one partner to another, through the retirement of older family members, or on the occasion of the death or resignation of an executive owning shares in the firm. The chief technical features of Section 302 confirm that the section contemplates an advance understanding or agreement by the shareholders. Thus, a shareholder desiring to redeem a portion of his shares can count on meeting the 80 per cent ownership test of Section 302(b)(2) only if he knows precisely how many shares, if any, are to be redeemed by others at the same time. Similarly, a complete termination of interest under Section 302(b)(3) depends upon the company's ability to acquire all of the redeeming shareholder's stock, which may in turn depend upon the willingness of other shareholders to retain all or most of theirs. These provisions were developed to permit and encourage taxpayers to act in relatively certain reliance on their applicability in a given case, and it is clear that they contemplate effective planning based on more or less formal agreement among the shareholders as to who will and who will not present his shares for redemption. Admittedly, Section 302(b)(1) is not limited on its face to planned redemptions—indeed, it is not limited on its face in any way at all. The immediate legislative history of the provision, however, indicates that it was intended chiefly to exempt redemptions of non-voting preferred stock which occur without voluntary action by the shareholder.[14] The Service, apart from its silence on the question of share repurchasing, has generally been unwilling to concede that the provision has more than a minor role to play.

By contrast, publicly held corporations which adopt widescale share repurchasing programs are motivated by a very different set of considerations and have different goals than are typical of Section 302 transactions. In most instances, the motives are those generally associated with partial liquidation—that is, to avoid the accumulation of liquid assets in excess of normal expansion requirements. To meet this objective the company sets aside for distribution an amount that represents the excess of current earnings over the sum of normal dividends plus needed additions to plant and working capital, or some fraction thereof. The company is indifferent to how many shares that amount will repurchase, although it might in prudence set an upper limit on the price it will pay. It is equally indifferent to the number or the identity of the shareholders who choose to sell. Indeed, all of the company's shareholders would be welcome to participate in the distribution by disposing of a portion of their shares, and there is even the theoretical, if not the practical, possibility that the distribution will turn out to be pro rata.

These factors, together with the point that such distributions are likely to occur annually or at more or less regular intervals, suggest that there is a fundamental dissimilarity between the repurchase of shares by public companies and the occasional redemption transactions thought typical of Section 302. It is true, as a practical matter, that redemptions are likely to be carried out on a non-pro rata basis in both situations. In the public case, however, the non-pro rata factor results from the differing investment decisions of the individual shareholders acting independently of one another, and in that sense is accidental. The funds appropriated for distribution are available to all of

14. S. Rep. No. 1622, 83d Cong., 2d Sess. 44-5 (1954); *see* Treas. Reg. § 1.302-2(a) (1955).

the shareholders equally until the distribution is completed; each shareholder has an option to accept or reject his proportionate share by surrendering or withholding his stock. The choice he makes depends on the medium of payment—cash or an increased stock interest—that he prefers. Moreover, the distribution generally will occur regardless of which or how many shareholders elect to participate in it. By contrast, in the typical Section 302 case, the non-pro rata factor reflects a bargained-out agreement between selling and non-selling shareholders and is accomplished by design; the distribution is made only after the recipient's identity has been settled through prearrangement.

These dissimilarities suggest that the pattern of taxation normally associated with Section 302 is not properly applicable to the public corporation case. Under circumstances which typically include negotiation and prior agreement, Section 302 in effect disregards the non-redeeming shareholder's waiver of equal participation in the cash distribution and treats the redemption as a complete description of the event. But in the public case, where shareholders are free to participate in the distribution at their own discretion, the appropriate tax pattern, recognizing the factor of individual choice, might well conform to the two-step characterization described earlier.[15] The distribution would then be regarded as a pro rata dividend to all of the company's shareholders, sellers and non-sellers alike, followed by such stock sales as actually do occur. All shareholders would receive a dividend taxable as ordinary income and would add this amount to the basis of their shares. Selling shareholders would then recognize capital gain (or loss) measured by the difference between the amount realized on the sale and the basis of the shares sold, such basis being increased to reflect the amount taxed as a dividend.

To illustrate, assume that *A* and *B* each own 100 shares of a publicly held corporation which has 1,000,000 shares outstanding and which decides to repurchase 50,000 shares of its own stock at a total cost of $1,000,000. Assume that *A*, whose basis for his 100 shares is $2,500, elects to retain all of his shares, while *B*, whose basis is $1,500, elects to sell all of his. Under the view taken here, both *A* and *B* receive a taxable dividend of $100 ($1 per share). *A*'s basis is increased to $2,600, *B*'s to $1,600. If the sale price of *B*'s shares is $2,000, *B* has a capital gain of $400 ($2,000, amount realized, less basis of $1,600) in addition to the dividend of $100. Similarly, if *A* later sells his shares for $2,000,

15. *See* Cohen *et al.*, *supra* note 13, at 16.

he then has a capital loss of \$600 (\$2,600, basis, less \$2,000, amount realized) in addition to the \$100 dividend previously included. In *B*'s case (as in *A*'s) nothing turns on whether the stock sale can actually be traced to the corporation as purchaser, nor on whether repurchases are made in the market or through public invitation to tender. It is sufficient that *A* and *B* were both stockholders of record on the date the distribution took place. The consequence is that each receives a taxable dividend which increases the basis of his shares for the purpose of computing gain or loss on subsequent sale, and it is not important whether such sale occurs at the same time or later.

The argument, then, is that share repurchases by public companies should be treated as dividends to both sellers and non-sellers for tax purposes, and that the presence of a non-pro rata factor ought not to be accepted as a dividend defense in this situation. Some support for this position can be found, by way of analogy, in Section 305 (b)(2), which provides that stock dividends, normally non-taxable on receipt, are to be taxed as ordinary income when the shareholder is free to elect to receive the dividend in stock or cash. For example, if a corporation declares a dividend payable in its own shares, but with the provision that any shareholder may elect cash instead, shareholders who choose to receive stock are required to include the shares received in income at their fair market value. The section treats the shareholder as if he had received cash plus subscription rights, or as if he had first received cash and then had reinvested the cash in additional shares.

What is striking about Section 305(b)(2) in the present context is that it extends ordinary dividend treatment to a transaction which has an economic effect similar or identical to share repurchasing. Thus, assume that *A* and *B* each own 50 per cent of a corporation's outstanding stock and that it is agreed to increase *A*'s interest to 60 per cent and to reduce *B*'s interest to 40 per cent. The desired result can be achieved either (1) by redeeming enough shares from *B* for cash so that his participation is brought down to 40 per cent, or (2) by distributing the same amount of cash to *B* without redeeming any of his shares but with *A* electing to receive a stock dividend, in lieu of cash, sufficient to increase his interest to 60 per cent. Apart from taxes, nothing turns on the procedure actually adopted. From a tax standpoint, however, Section 302 and Section 305(b)(2) produce conflicting results. Under 302, *B* receives capital gain and *A* no income at all; under 305(b)(2) both receive a dividend. These results diverge, moreover, even though the same element of non-pro rata distribution appears in each.

While the two provisions thus respond differently to equivalent transactions, the apparent conflict between them has not proved troublesome so far. Indeed it appears to have gone unnoticed.[16] The reason, presumably, is that apart from the swift growth of share repurchasing in recent years, stock redemptions have been employed almost entirely to carry out planned withdrawals from participation in closely-held corporations, while optional stock dividend arrangements have been used largely as a means of satisfying the diverse preferences of public investors for current income or capital appreciation. Section 305(b)(2) makes it reasonably clear, however, that Congress did not intend optional dividends—dividends which are elective as to medium of payment—to escape from treatment as taxable pro rata distributions; and one would expect that this attitude would apply as readily when optional dividends are cast in the form of stock redemptions as when they take the shape of a right to receive additional shares.

The Treasury has recently demonstrated its concern with the problem of elective dividends by adopting a revised set of regulations under Section 305(b).[17] These regulations are directed at two types of optional stock dividend plans which are designed to give shareholders a choice between cash and additional shares of stock without producing a tax on those who choose stock. Under the first plan a corporation issues two classes of common stock; dividends are payable in equal amounts on both classes but the corporation is free to declare a cash dividend on one class and a stock dividend on the other. The second involves a special type of stock which is not entitled to cash dividends. Instead, it is convertible into an increasing number of ordinary dividend-paying common shares. It has been assumed by some that these

16. The President's Tax Reform Proposals, which appeared too late to be reflected in this paper, do relate stock dividends to stock redemptions by extending Section 305(b) to a planned series of redemptions in which all shareholders are given an option to redeem a stated proportion of their shares at periodic intervals. Both the redeeming and the non-redeeming shareholders would be considered to have received taxable dividends. TAX REFORM PROPOSALS: THE MESSAGE FROM THE PRESIDENT OF APRIL 21, 1969, *Public Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., at 224-25 (Comm. Print April 22, 1969). The new measure, which is very briefly described in the President's message, is apparently quite limited in scope. Thus, although the great bulk of shares bought by public companies is purchased through brokers in the open market, the new provision seems to extend only to preannounced periodic tender offers. In addition, it would seem to be limited to cases in which the company offers to redeem from each shareholder a fixed percentage of his shares. Apparently excluded is the much more common situation in which the total amount of cash to be distributed is predetermined, and the company then takes up shares in any proportion until the fund dedicated to repurchasing is exhausted. In the latter case, as suggested in the text, the appropriate result is reached if each shareholder is treated as if he had received a dividend in the amount of his pro rata share of the total cash distribution; additional amounts received by selling shareholders produce capital gain or loss.

17. Treas. Reg. §§ 1.305-2, 1.305-3 (1969).

plans would escape taxability under Section 305(b). The revised regulations, however, through a broad construction of the technical requirements of that provision, treat the receipt of stock dividends in the first case and of additional conversion rights in the second as taxable dividends.

Though likely to breed controversy, the regulations reach results which seem completely consistent with the purpose of Section 305(b)—to prevent shareholders from taking advantage of the tax-free status of stock dividends in cases in which cash dividends of equal value are also available. It may be, however, that in closing off the optional dividend devices just described, the regulations will further stimulate corporate financial managers to resort to share repurchasing as an alternate technique. Section 305(b) would seem to be of no direct help to the Treasury in dealing with the latter procedure, since the language of the section, however broadly read, can hardly be stretched to cover redemptions. Thus, uniformity in the tax treatment of elective dividends depends on the perception that when shares are reacquired by means of a public tender or through transactions in the market, the tax pattern normally associated with Section 302 is inapplicable. In turn, this perception depends both on realizing that share repurchase is ultimately a substitute for pro rata dividends and on being aware that Section 302 is a provision of limited scope and purpose.

III. Conclusion

The assumptions which underlie the view that share repurchases are not equivalent to ordinary taxable dividends seem less than completely satisfactory. There is little doubt, in the great majority of cases, that share repurchase is part of the firm's dividend decision.[18] In an analogous area, Congress has made it clear that optional dividends are to be taxed as ordinary pro rata distributions when they take the form of stock or cash, and the Treasury has recently taken steps to prevent circumvention of that principle. In economic effect, optional redemptions of common stock cannot convincingly be distinguished from optional common stock dividends. More specifically, Section 302, which normally protects stock redemptions from dividend treatment, does not appear to have been worked out with wide-scale share repurchasing in mind, and it is arguable that the section lacks jurisdiction over transactions of the sort described.

18. *See* J. VAN HORNE, *supra* note 4, at 208.

The question raised here about stock redemptions is part of a larger problem which concerns the relationship of the federal income tax to the development of optional dividend policies by publicly held corporations seeking to satisfy conflicting preferences among their shareholders. On the standard assumption that some investors prefer current income while others prefer capital appreciation, the most acceptable procedure, apart from tax impediments, "would be to give each stockholder the option of taking dividends either in cash or in stock of equivalent value, as he preferred."[19] Since the tax law treats cash dividends as ordinary income, a choice of cash or stock can best be achieved by retaining all earnings in the corporation and permitting those shareholders who desire current income to declare their own dividends, in effect, by selling small amounts of stock annually with resulting capital gain or loss. Distribution of regular annual stock dividends representing the current year's earnings, which can then be sold by those who desire current income, would afford shareholders the same opportunity.[20] But if the corporation finds it desirable to distribute cash assets —either because the market would react adversely to the total absence of cash dividends or because management regards the company as overcapitalized—the tax law customarily treats the amounts received as ordinary taxable income. Whatever may be said of its rationality, the distinction between earnings distributed and earnings retained is absolutely vital under the taxing system as it stands, and change is inconceivable apart from a broad legislative reworking of the law. Self-help measures, such as share repurchasing, which distort the customary and intended pattern of taxation should therefore be unwelcome to the Treasury, and where a technical basis for opposition exists they should be opposed.

19. B. GRAHAM, D. DODD & S. COTTLE, SECURITY ANALYSIS 502 (1962).
20. Smith, *Tax Treatment of Dividends*, in HOUSE WAYS & MEANS COMM. TAX REVISION COMPENDIUM 1543, 1548-9 (Comm. print 1959).